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No. ———

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

CITY OF CHARLOTTESVILLE, VIRGINIA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
COLUMBIA GAS TRANSMISSION CORPORATION,
COLUMBIA GULF TRANSMISSION COMPANY,
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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January 16, 1986

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QUESTIONS PRESENTED

The United States Court of Appeals for the District of Columbia Circuit ("Court of Appeals") has affirmed an opinion of the Federal Energy Regulatory Commission ("Commission") that permits interstate natural gas pipelines to collect federal income tax ("FIT") allowances in their rates which do not share with their ratepayers the substantial tax savings that the pipelines enjoy by virtue of their participation in consolidated tax returns with other affiliated corporations. Rather, the Commission assumes for purposes of this calculation, contrary to fact, that the pipelines file their own separate federal income tax returns. The Questions Presented are:

1. Whether the Court of Appeals incorrectly held that this Court's opinion in *FPC v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967) ("*United*"), merely gave the Commission the option, if it so chose, to share consolidated tax savings with pipeline ratepayers, rather than requiring the Commission to share these savings in some fashion with the ratepayers.

2. Whether the Court of Appeals incorrectly dismissed as "*dicta*" passages from this Court's *United* opinion that conflicted with the Court of Appeals' reasoning in affirming the Commission's legal authority to disregard consolidated tax savings in setting pipeline FIT allowances.

3. Whether the Court of Appeals improperly disregarded case law concerning the "actual taxes paid" principle in holding that the Commission has no obligation to require pipelines to share their consolidated tax savings with their ratepayers.

4. Whether the Court of Appeals erred in affirming the Commission's method of calculating pipeline FIT allowances when the end result of that method may well be a pipeline's collection of a substantial FIT allowance when the consolidated group of which the pipeline is a member pays no federal income taxes at all.

PARTIES BELOW

The following parties appeared in the judicial review proceeding in the Court of Appeals below:

CITY OF CHARLOTTESVILLE, VIRGINIA

FEDERAL ENERGY REGULATORY COMMISSION

COLUMBIA GAS TRANSMISSION CORPORATION AND COLUMBIA GULF TRANSMISSION COMPANY *

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

AMERICAN PUBLIC GAS ASSOCIATION **

This protracted administrative litigation commenced before the Federal Energy Regulatory Commission's ("FERC") predecessor agency, the Federal Power Commission ("FPC"),*** in 1973. In its earlier stages, numerous other parties appeared; however, the parties listed above were the only participants in the judicial review proceeding that is the subject of this petition.

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* As explained more fully below, these two companies are wholly-owned subsidiaries of the Columbia Gas System, Inc.

** This party entered an appearance below as an *amicus curiae* in support of the Petitioner, and has represented that it does not wish to be considered a Respondent in this Court under Sup. Ct. R. 19.6.

*** On October 1, 1977, the FPC was abolished and its functions transferred to the newly-formed FERC. *See* the Department of Energy Organization Act, Section 402(a), 42 U.S.C. § 7172(a). The Petitioner will refer to both entities as the "Commission."

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	2
STATUTES INVOLVED	2
STATEMENT OF THE CASE	4
A. Procedural History	4
B. Statement of Relevant Facts	6
1. *The Consolidated Tax Savings Issue*	6
2. *The Columbia Pipelines' Consolidated Tax Savings*	8
REASONS FOR GRANTING THE WRIT	10
I. THE COURT OF APPEALS' DECISION BELOW DIRECTLY CONFLICTS WITH THIS COURT'S *UNITED* DECISION	10
II. THE COURT OF APPEALS ERRONEOUSLY CONCLUDED THAT THE COMMISSION HAD NO OBLIGATION EVEN TO ATTEMPT TO APPROXIMATE THE COLUMBIA PIPELINES' SHARE OF THE COLUMBIA GAS SYSTEM INC.'S FEDERAL INCOME TAX LIABILITY	22
III. THE COMMISSION'S METHOD OF CALCULATING PIPELINE FEDERAL INCOME TAX ALLOWANCES DOES NOT SHARE CONSOLIDATED TAX SAVINGS WITH PIPELINE RATEPAYERS; HENCE, IT CANNOT STAND UNDER *UNITED* AND THE "ACTUAL TAXES PAID" PRINCIPLE	25
CONCLUSION	26

TABLE OF AUTHORITIES

COURT DECISIONS Page

Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966) 24
American Public Gas Association v. FPC, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978) 18, 22
Cities Service Gas Co. v. FPC, 337 F.2d 97 (10th Cir. 1964) 10
City of Charlottesville v. FERC, 661 F.2d 945 (D.C. Cir. 1981) 2, 5, 11, 16
City of Chicago v. FPC, 458 F.2d 731 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972) 23
City of Chicago v. FPC, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied*, 390 U.S. 945 (1968) 24
City of Lexington v. FPC, 295 F.2d 109 (4th Cir. 1961) 24
Connecticut Natural Gas Corp. v. Public Utilities Control Authority, 183 Conn. 128, 439 A.2d 282 (1981) 20
El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961) 24
Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) 19
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) 25
FPC v. Memphis Light, Gas and Water Division, 411 U.S. 458 (1973) 19, 24
FPC v. United Gas Pipe Line Co., 393 U.S. 71 (1968) (*per curiam*) 10
FPC v. United Gas Pipe Line Co., 386 U.S. 237 (1967) ..... *passim*
Galveston Electric Co. v. City of Galveston, 258 U.S. 388 (1922) 7
Indianapolis Airport Authority v. American Airlines, Inc., 733 F.2d 1262 (7th Cir. 1984) 20
Maryland v. Louisiana, 451 U.S. 725 (1981) 19
Memphis Light, Gas and Water Division v. FPC, 500 F.2d 798 (D.C. Cir. 1974) 19, 24
Mercer v. Theriot, 377 U.S. 152 (1964) 16

TABLE OF AUTHORITIES—Continued

Page

Michaelson v. New England Telephone and Telegraph Co., 121 R.I. 722, 404 A.2d 799 (1979) 20
Mountain States Telephone and Telegraph Co. v. Public Utilities Commission of Colorado, 195 Colo. 130, 576 P.2d 544 (1978) (*en banc*) 20
Papago Tribal Utility Authority v. FERC, 773 F.2d 1056 (9th Cir. 1985) 20
Public Systems v. FERC, 709 F.2d 73 (D.C. Cir. 1983) 23, 24
Public Systems v. FERC, 606 F.2d 973 (D.C. Cir. 1979) 19, 24
Public Utilities Commission of Colorado v. FERC, 660 F.2d 821 (D.C. Cir. 1981), *cert. denied*, 456 U.S. 944 (1982) 19
Rochester Gas and Electric Corp. v. Public Service Commission of New York, 754 F.2d 99 (2d Cir. 1985) 20
Tenneco Oil Co. v. FERC, 571 F.2d 834 (5th Cir.), *cert. denied*, 439 U.S. 801 (1978) 16, 17, 18, 22
United Gas Pipe Line Co. v. FPC, 388 F.2d 385 (5th Cir. 1968), *reversed and remanded sub nom., FPC v. United Gas Pipe Line Co.*, 393 U.S. 71 (1968) (*per curiam*) 10
United Gas Pipe Line Co. v. FPC, 357 F.2d 230 (5th Cir. 1966) (*per curiam*), *reversed and remanded sub nom., FPC v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967) 10
United States v. Transamerica Corp., 345 F.2d 765 (9th Cir. 1965) 14
Washington Gas Light Co. v. Public Service Commission of the District of Columbia, 450 A.2d 1187 (D.C. App. 1982) 20
Williams v. Washington Metropolitan Area Transit Commission, 415 F.2d 922 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1081 (1969) 19

ADMINISTRATIVE DECISIONS

Columbia Gulf Transmission Co., 20 FERC (CCH) ¶ 61,036 (1982) 6

TABLE OF AUTHORITIES—Continued

Page

Columbia Gulf Transmission Co., Opinion No. 47, 8 FERC (CCH) ¶ 61,002, *reh'g denied*, Opinion No. 47-A, 9 FERC (CCH) ¶ 61,355 (1979), *reversed and remanded sub nom., City of Charlottesville v. FERC*, 661 F.2d 945 (D.C. Cir. 1981) 2, 5

Columbia Gulf Transmission Co., 8 FERC (CCH) ¶ 63,009 (1977), *reversed*, Opinion No. 47, 8 FERC (CCH) ¶ 61,002, *reh'g denied*, Opinion No. 47-A, 9 FERC (CCH) ¶ 61,335 (1979), *reversed and remanded sub nom. City of Charlottesville v. FERC*, 661 F.2d 945 (D.C. Cir. 1981) 2, 5, 8

Columbia Gas Transmission Corp., 54 F.P.C. 2578 (1975) 5

Florida Gas Transmission Co., Opinion No. 611, 47 F.P.C. 341 (1972) 8

STATUTES

Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, Section 207(a)(1) 13

Internal Revenue Code

26 U.S.C. § 172(b)(1)(B) 13
26 U.S.C. § 1501 ..... 5, 7, 14
26 U.S.C. § 1502 14

Natural Gas Act

Section 2(3), 15 U.S.C. § 717a(3) 4
Section 4, 15 U.S.C. § 717c 2, 4, 6
Section 19(a), 15 U.S.C. § 717r(a) 5, 6
Section 19(b), 15 U.S.C. § 717r(b) 2, 5, 6

28 U.S.C. § 1254(1) 2

MISCELLANEOUS

Columbia Gulf Transmission Co., FERC Docket Nos. RP75-105, *et al.*, "Reply Brief On Remand On Behalf Of Columbia Gulf Transmission Company and Columbia Gas Transmission Corporation," dated November 17, 1982 9

TABLE OF AUTHORITIES—Continued

Page

Columbia Gulf Transmission Co., FERC Docket No. RP84-74, Rate Application (filed April 30, 1985), Statement H(3) 13

Columbia Gas Transmission Corp., FERC Docket No. RP84-75, Rate Application (filed April 30, 1985), Statement H(3) 13

R. Stern and E. Gressman, *Supreme Court Practice*, § 6.4 (5th ed. 1978) 16

The Washington Post, Sept. 18, 1985, p. A17 13

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COLUMBIA GULF TRANSMISSION COMPANY,
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Petitioner, City of Charlottesville, Virginia ("City"), respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit ("Court of Appeals") entered in *City of Charlottesville v. FERC*, D.C. Cir. No. 83-2059, on October 18, 1985.

OPINIONS BELOW

The opinion and judgment of the Court of Appeals were issued on October 18, 1985, in *City of Charlottesville v. FERC*, D.C. Cir. No. 83-2059 ("*Charlottesville II*"). The opinion is reported at 774 F.2d 1205 (App.

1a-37a). On December 2, 1985, the City filed with the Court of Appeals a timely suggestion for rehearing *en banc*. The Court of Appeals issued an order denying this suggestion on January 13, 1986. (App. 101a.).

The administrative opinion of the Commission under review in *Charlottesville II* was Opinion No. 173, issued on June 22, 1983, in *Columbia Gulf Transmission Co.*, Docket No. RP75-105, and *Columbia Gas Transmission Corp.*, Docket No. RP75-106, 23 FERC (CCH) ¶ 61,396 (1983)[1] (App. 38a-98a). The Commission denied the City's application for rehearing of Opinion No. 173 without opinion. 24 FERC (CCH) ¶ 61,258 (1983) (App. 99a).[2]

JURISDICTION

The Court of Appeals entered its judgment and opinion in the proceeding below on October 18, 1985. The City filed a timely suggestion for rehearing *en banc* on December 2, 1985. On January 13, 1986, the Court of Appeals issued an order denying the City's suggestion.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act ("NGA"), 15 U.S.C. § 717r(b).

STATUTES INVOLVED

This case arises under Section 4 of the NGA, 15 U.S.C. § 717c. The pertinent portions of NGA Section 4 are as follows:

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[1] Commerce Clearing House, Inc. ("CCH") publishes the official reports of the FERC in its Federal Energy Regulatory Commission Reporter.

[2] The proceeding below was the result of a court-ordered remand in *City of Charlottesville v. FERC*, 661 F.2d 945 (D.C. Cir. 1981). The Commission opinions reviewed in that opinion consisted of the initial decision of the Presiding Administrative Law Judge, 8 FERC (CCH) ¶ 63,009 (1977); Opinion No. 47, 8 FERC (CCH) ¶ 61,002 (1979); and Opinion No. 47-A, 9 FERC (CCH) ¶ 61,355 (1979).

§ 717c. *Rates And Charges.*

(a) *Just and reasonable rates and charges.* All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

* * * *

(d) *Changes in rates and charges; notice to Commission.* Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect . . .

(e) *Authority of Commission to hold hearings concerning new schedule of rates.* Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; . . . and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. . . . At any hearing involving a rate or charge sought to be increased, the burden of proof to

show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

STATEMENT OF THE CASE

A. Procedural History

This litigation grew out of four rate increase applications filed with the FPC by Columbia Gas Transmission Corporation and Columbia Gulf Transmission Company ("Columbia Pipelines") in 1973 and 1975. As interstate natural gas pipelines regulated by the Commission under the NGA, the Columbia Pipelines had to submit these rate increase applications to the Commission for scrutiny, as required by NGA Section 4. Numerous customers of the Columbia Pipelines, including the City,[3] and other interested parties participated in the administrative proceedings held to consider these rate increase applications. Eventually the participants reached a settlement concerning all aspects of the Columbia Pipelines' rate filings except the federal income tax ("FIT") allowances to be included in the Columbia Pipelines' rates.

The City contended that, consistent with historic Commission policy and Supreme Court precedent, the Commission should take into account the substantial tax savings that the Columbia Pipelines achieved by joining in a consolidated FIT return with their parent holding company, the Columbia Gas System, Inc. ("CGS"), and

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[3] The City is a "municipality" as that term is defined in Section 2(3) of the NGA, 15 U.S.C. § 717a(3). It owns and operates the gas distribution system serving its community and purchases gas supplies for resale therein directly from Columbia Gas Transmission Corporation ("Columbia Gas") and indirectly from Columbia Gulf Transmission Company ("Columbia Gulf"). As a customer of the Columbia Pipelines, the City has historically been an active participant in the Columbia Pipelines' NGA Section 4 rate cases.

its other subsidiaries in calculating their FIT allowances.[4] The Columbia Pipelines, on the other hand, advocated calculating their FIT allowances as though each were an independent entity filing a separate FIT return, *i.e.*, as if each "stood alone." Accordingly, the settlement reserved this "consolidated tax savings" issue for administrative hearing and decision.

The Commission approved the settlement on December 1, 1975, and, consonant with its terms, ordered the consolidated tax savings issue to be tried. 54 F.P.C. 2578 (1975). An Administrative Law Judge subsequently held a hearing at which the parties presented evidence supporting their respective positions. On July 7, 1977, the Presiding Judge issued his Initial Decision rejecting the Columbia Pipelines' position that they should calculate their FIT allowances on a "stand-alone" basis and ordering the Columbia Pipelines to reflect their consolidated tax savings in calculating their FIT allowances. 8 FERC (CCH) ¶ 63,009 (1977).

On July 2, 1979, the Commission issued Opinion No. 47, in which it reversed the Presiding Judge's Initial Decision. 8 FERC (CCH) ¶ 61,002 (1979). It held that the Columbia Pipelines could calculate their FIT allowances on a "stand-alone" basis, and expressed its general policy preference for this method. On December 20, 1979, the Commission denied the City's application for rehearing under Section 19(a) of the NGA, 15 U.S.C. § 717r (a), in its Opinion No. 47-A. 9 FERC (CCH) ¶ 61,355 (1979). The City then petitioned for review in the Court of Appeals under Section 19(b) of the NGA, 15 U.S.C. § 717r(b).

In *City of Charlottesville v. FERC*, 661 F.2d 945 (D.C. Cir. 1981) (*"Charlottesville I"*), the Court of

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[4] Under the Internal Revenue Code, an affiliated group of corporations has the privilege of filing a consolidated return for a taxable year in lieu of each corporation filing a separate return. *See* 26 U.S.C. § 1501.

Appeals reversed Opinion Nos. 47 and 47-A, holding that the Commission had presented insufficient evidence to support its adoption of its new "stand-alone" policy. The Court of Appeals accordingly remanded the case to the Commission for further proceedings not inconsistent with its opinion. The Commission in turn remanded the case to its Chief Administrative Law Judge for expedited evidentiary proceedings. 20 FERC (CCH) ¶ 61,036 (1982). The Chief Administrative Law Judge held an expedited evidentiary hearing, and the parties completed their briefing of the case on November 17, 1982.

On June 22, 1983, the Commission issued its Opinion No. 173, in which it reaffirmed its policy decision to permit interstate pipelines to collect "stand-alone" FIT allowances from their ratepayers. 23 FERC (CCH) ¶ 61,396 (1983) (App. 38a-98a). The City sought rehearing of Opinion No. 173 on July 22, 1983, under NGA Section 19(a), 15 U.S.C. § 717r(a). The Commission issued a notice on August 22, 1983, denying the City's application for rehearing without opinion. 24 FERC (CCH) ¶ 61,258 (1983) (App. 99a). The City accordingly petitioned for judicial review in the Court of Appeals for the second time on October 6, 1983, under NGA Section 19(b), 15 U.S.C. § 717r(b).

On October 18, 1985, the Court of Appeals issued its *Charlottesville II* opinion, affirming the Commission's Opinion No. 173 in all respects. (App. 1a-37a.) Judgment was entered that same day. (App. 100a.) The City filed a suggestion for rehearing *en banc* with the Court of Appeals on December 2, 1985. This suggestion was denied by an order of the Court of Appeals issued on January 13, 1986. (App. 101a.)

B. Statement of Relevant Facts

1. *The Consolidated Tax Savings Issue*

Under NGA Section 4(a), the Commission must ensure that the rates of natural gas pipelines are "just and reasonable." The Commission fulfills this duty by

examining the various costs and expenses that a pipeline incurs in providing service to its customers, excluding costs that it finds excessive, imprudent, or not actually incurred. The Commission then derives a "just and reasonable" rate that will permit the pipeline to recover its proper costs and expenses, including a reasonable rate of return.

One of the expenses that a pipeline is entitled to recover in its rates is its FIT expense.[5] The Commission must therefore determine a just and reasonable FIT allowance for each pipeline that it regulates. Many natural gas pipelines, however, are not separate corporate entities, but are one of a number of subsidiaries of a corporate parent. This fact complicates the determination of their FIT allowances.

Under the Internal Revenue Code, 26 U.S.C. § 1501, the entire corporate "group" may file a joint tax return, known as a "consolidated return," and use the tax losses of its "loss" members to offset the income of its income-producing members. Affiliated corporate groups generally use this device to reduce the total FIT liability of the group below what it would be if each member filed a separate FIT return, resulting in a tax savings. This occurs, *inter alia*, because the group uses the losses of its "loss" members immediately to offset the taxable income of its "income-producing" members. Otherwise, each loss company would have to carry its own losses over for possible use in other tax years.

In calculating the FIT allowance of a pipeline that is a member of such a corporate group, the issue arises of whether the Commission should take the consolidated tax savings of the pipeline member into account, sharing these savings with the pipeline's ratepayers, or whether it should calculate the FIT allowance as if the pipeline

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[5] *See, e.g.*, Galveston Electric Co. v. City of Galveston, 258 U.S. 388, 399 (1922).

were an independent entity filing a separate tax return, *i.e.*, as if it "stood alone." This, in a nutshell, has been the issue throughout this prolonged litigation.

For many years, the Commission routinely reduced the FIT allowances of interstate pipelines to reflect consolidated tax savings. It did so on the principle that the FIT allowance should, as nearly as possible, reflect the consolidated tax savings allocable to the pipeline, rather than the larger hypothetical FIT liability it would have paid had it filed a separate return. The Supreme Court upheld this policy in *FPC v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967) (*"United"*). In 1972, however, the Commission announced its intent in *Florida Gas Transmission Co.*, Opinion No. 611, 47 F.P.C. 341 (1972) (*"Florida Gas"*), to adopt a "stand-alone" policy.

The *Florida Gas* decision was never reviewed in the courts, and hence was never subject to judicial scrutiny. This litigation has by default become the first judicial test of the Commission's departure from the Commission policy affirmed by this Court in its *United* decision.[6]

2. *The Columbia Pipelines' Consolidated Tax Savings*

Since 1947, CGS has filed a consolidated tax return on behalf of itself and all its subsidiaries, including the Columbia Pipelines and their predecessor entities. Over the years, CGS has saved scores of millions of dollars using this device.[7] Prior to 1972, these tax savings were

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[6] Though the subject case involves only the period 1975-76, the Commission in Opinion No. 173 announced that its "stand-alone" policy would apply "when any jurisdictional company, be it a pipeline or an electric utility, joins with other businesses in filing a consolidated return." 23 FERC (CCH) ¶ 61,396 at p. 61,870 n. 8. (App. 45a). Hence, this adjudication of the Columbia Pipelines' FIT allowances has been transformed into a quasi-rulemaking in which a rule of general applicability is being announced and tested.

[7] The actual amount of the Columbia Pipelines' consolidated tax savings has been a contested issue throughout this litigation. The

reflected in the Columbia Pipelines' FIT allowances. After the Commission's *Florida Gas* decision, however, they began calculating their FIT allowances on a "stand-alone" basis, and have continued to do so.

The City has argued throughout this litigation that the Commission, consistent with its pre-*Florida Gas* policy, should attempt to approximate the Columbia Pipelines' allocated share of CGS' actual consolidated tax savings when it calculates their FIT allowances. Specifically, the City has advocated the use of an "effective" tax rate, rather than the corporate FIT rate, to calculate these allowances.[8] The City, however, is less concerned about the actual formula used to share the Columbia Pipelines' consolidated tax savings with their ratepayers than it is that there be *some* equitable sharing of these savings.

City has contended that the Columbia Pipelines' "stand-alone" FIT allowances exceeded the consolidated FIT liability of CGS, resulting in windfall profits to the Columbia Pipelines of many millions of dollars. The City believes that it proved this fact in the administrative proceedings below. *See, e.g.*, R. 695, 743-45, 1493-95. The Respondents, however, dispute the size of the windfall. Suffice it to say here that the Columbia Pipelines stated to the Commission in their November 17, 1982 "Reply Brief on Remand" (at page 11) that "[t]he point that Charlottesville goes to such great lengths to make—that the filing of a consolidated tax return reduces the Columbia System's tax liability—is an obvious one and has never been contested by the Columbia pipelines."

[8] The specific method that the City proposed in 1976—which method was adopted by the Presiding Judge in his Initial Decision—showed an effective tax rate for Columbia Gas of 31.9% and for Columbia Gulf of 31.4%. R. 420B-23B. (Citations to the record compiled in the original administrative proceeding are denoted by a "B".) The corporate FIT rate during this same time period was 48%. (It has since been changed to 46%.) The result of using the City's method for the time period at issue in this case would have been FIT allowances for the two pipelines of $26.4 million and $14.3 million, respectively, versus their "stand alone" FIT allowances of $49.7 million and $28.8 million, respectively, sanctioned by the Commission and collected by the Columbia Pipelines subject to refund. *Id.*; 8 FERC (CCH) ¶ 63,009 at p. 65,150 (1977).

REASONS FOR GRANTING THE WRIT

I. THE COURT OF APPEALS' DECISION BELOW DIRECTLY CONFLICTS WITH THIS COURT'S UNITED DECISION

The leading Supreme Court opinion on the consolidated tax issue is the *United* decision. In that case, United Gas Pipe Line Company ("United") contested in the United States Court of Appeals for the Fifth Circuit the FIT allowance that the Commission had awarded it. United claimed that the allowance was unjustly and unreasonably low because the Commission had impermissibly considered United's participation in a consolidated return with its affiliates in calculating the allowance. In *United Gas Pipe Line Co. v. FPC*, 357 F.2d 230 (5th Cir. 1966) (*per curiam*), the Fifth Circuit vacated the Commission's order, relying on the United States Court of Appeals for the Tenth Circuit's earlier opinion in *Cities Service Gas Co. v. FPC*, 337 F.2d 97 (10th Cir. 1964). The FPC then appealed the Fifth Circuit's decision to this Court.

In *United*, this Court reversed the Fifth Circuit and remanded the case for further consideration.[9] Acknowledging the general rule that "the income and expense of unregulated and regulated activities should be segregated," *United*, 386 U.S. at 243, the Court nonetheless rejected United's contention that the Commission had no power to apply the tax losses of United's unregulated affiliates to reduce United's FIT allowance, and hence its rates. The Court held that the Commission had authority to consider the tax losses of unregulated affiliates because United itself had voluntarily chosen to participate in the consolidated return, thus presenting the Commission with the question of "what portion of the single consolidated tax liability belonged to United." *Id.* The Court noted

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[9] The Fifth Circuit's opinion on remand, United Gas Pipe Line *Co. v. FPC*, 388 F.2d 385 (5th Cir. 1968), was reversed and remanded by this Court in FPC v. United Gas Pipe Line Co., 393 U.S. 71 (1968) (*per curiam*), for reasons not relevant here.

that "[a] proper allocation had to be made by the Commission." *Id.* Citing "the power and the duty of the Commission to limit cost of service to real expenses," *id.* at 245,[10] the Court affirmed both the Commission's decision to consider United's consolidated tax savings in calculating its FIT allowance and the specific method that the Commission used to share these savings with United's ratepayers.

Throughout this protracted litigation, the City has relied on *United* as precedent supporting its position that the Commission must consider consolidated tax savings in setting pipeline FIT allowances. In *Charlottesville I*, however, the Court of Appeals stated that the Supreme Court in *United* had "declared that the Commission has the power to take into account consolidated tax savings—generated from whatever source—when determining a company's cost of service tax allowance," but had also held "that there is no specific treatment mandated for the allocation of consolidated tax savings." *Charlottesville I*, 661 F.2d at 948. The Court of Appeals therefore found that the Commission had the legal authority to adopt a "stand-alone" policy, but that it lacked factual support for its action. *Id.* at 953. Hence, it remanded the case to the Commission for further proceedings. *Id.* at 954.

In *Charlottesville II*, the Court of Appeals again held that the *United* decision authorized, but did not require, the Commission to reflect consolidated tax savings in pipeline FIT allowances. *Charlottesville II*, 774 F.2d at 1208 (App. 5a). Later in its opinion, the Court of Appeals again discussed *United*:

> [I]n arguing that the pipelines' tax expense cannot exceed the consolidated tax liability Charlottesville does no more than place the Commission's own now-

[10] The legal principle that the Commission may not award a regulated pipeline an FIT allowance that disregards the pipeline's permanent tax savings has come to be called the "actual taxes paid" doctrine.

> disavowed child on its doorstep. That is the principle the Commission explicitly recited in its 1963 *Cities Service* decision, imposing a "flow-through" rather than a "stand-alone" methodology. "[T]he amount of the consolidated tax payment," it said, "is the only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates"; and the purpose of tax allowances is "not to insure that other components of a complex corporate system are enabled to 'cash-in' on their tax losses." *Cities Service Gas Co.*, 30 F.P.C. 158, 162 (1963). In upholding the Commission's action, the Supreme Court appeared to adopt this argument as not permitting but requiring flow-through, *see FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 243-44, 87 S.Ct. 1003, 1007, 18 L.Ed.2d 18 (1967); *id.* at 254, 87 S.Ct. at 1012 (Harlan, J., dissenting), but as the Fifth Circuit explicitly said in *Tenneco, see* 571 F.2d at 843, and as we plainly implied in *Charlottesville I, see* 661 F.2d at 952, those expressions were *dicta*.

Charlottesville II, 774 F.2d at 1216 (App. 21a-22a).

The passages of the *United* decision which the Court of Appeals dismissed as *dicta* (386 U.S. at 243-44) are the heart of the *United* decision, going to the very consolidated tax savings issue before this Court for decision. Moreover, the Court's statements therein directly conflict with the Court of Appeals' statements in *Charlottesville II*. For example, the Court of Appeals discussed in *Charlottesville II* why it believed the "stand-alone" method of calculating pipeline FIT allowances to be appropriate. In its discussion, it considered a hypothetical case where the consolidated group pays no federal income taxes:

> To take the harshest hypothetical case, if stand-alone is allowed the pipeline ratepayers may be assessed with a tax expense when the consolidated company in fact pays *no* taxes. We find that no obstacle to the Commission's action, neither in theory nor in economic reality. It is certainly reasonable to regard as no less real an economic detriment than cash pay-

> ment of tax assessments, the consumption of otherwise usable tax losses to forestall those assessments. Had the affiliates reporting the losses filed separately, the losses could have been carried forward and used to offset their own income the following fifteen years (or carried back to yield refunds for the previous three); or they could have been used to offset the profits of some other company with which (had the pipeline not been in the consolidated group) the parent would have chosen to affiliate; instead, the parent used them, in place of cash as it were, to eliminate tax liability. Economic detriment to the parent is undeniable, even if, since the losses fully "pay" the tax, the tax bill is zero.

Id. at 1215 (footnote omitted) (emphasis in original) (App. 20a-21a).[11]

Aside from containing basic factual errors,[12] the Court of Appeals' analysis runs directly contrary to this Court's pronouncements in *United*:

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[11] What the Court of Appeals deemed "the harshest hypothetical case" appears to have been the reality in recent years. A recent survey showed CGS to be one of 50 companies that paid no federal income tax or received a tax refund during the 1981-84 period. CGS received a tax refund of $15.9 million, on profits totalling $1,147.1 million. *The Washington Post*, Sept. 18, 1985, p. A17. The Columbia Pipelines, in their latest rate filings at the Commission, showed FIT allowances for the 12 months ended December, 1983, as adjusted, using the stand-alone methodology, of *$101.7 million* (Columbia Gas, Docket No. RP84-75, filed April 30, 1985, Statement H(3)) and *$28.5 million* (Columbia Gulf, Docket No. RP84-74, filed April 30, 1985, Statement H(3)).

[12] For example, the "carry forward" period for tax losses during the time period at issue in this case was seven years, rather than the fifteen years cited by the Court of Appeals. *See* Section 207(a)(1) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, *amending* 26 U.S.C. § 172(b)(1)(B). Moreover, the parent corporation does *not* have the option of excluding a pipeline subsidiary from its consolidated group unless it divests itself of ownership, because the Internal Revenue Code requires that all corporations that have been members of the affiliated group at any time

> Respondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the Commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.

United, 386 U.S. at 243-44. This Court explicitly stated in *United* that it would be an "untenable" result if a regulated pipeline collected a FIT allowance while the consolidated group of which it was a member paid no federal income taxes, while the Court of Appeals in *Charlottesville II* found this possible outcome to be "no obstacle" to the Commission's adoption of its "stand-alone" policy.

Moreover, in *United* this Court considered the Court of Appeals' "economic detriment" theory, *i.e.*, that the consolidated group would suffer an economic detriment if the Commission required consolidated tax savings arising from the tax losses of unregulated affiliates to be shared with pipeline ratepayers. The Court rejected this theory:

> It is true that the avoidance of tax and the reduction of the tax allowance are accomplished only by applying losses of unregulated companies to the in-

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during the taxable year consent to the consolidated return regulations. 26 U.S.C. §§ 1501, 1502; *see, e.g.*, United States v. Transamerica Corp., 345 F.2d 765, 768 (9th Cir. 1965).

> come of the regulated entity. But the Commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in these cases, themselves chose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. Such a private decision made by the affiliates, including the regulated member, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero . . . . But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in [Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945)] or [Panhandle Eastern Pipe Line Co. v. FPC, 324 U.S. 635 (1945)] forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses.

United, 386 U.S. at 244-45 (footnote omitted).

While the Court of Appeals attempted to dismiss the above-quoted passages of the Court's *United* opinion as *dicta*, *Charlottesville II*, 774 F.2d at 1216 (App. 22a), they clearly rebut the Court of Appeals' own rationale for finding that the Commission has the authority to adopt its "stand-alone" policy. Thus, it is most difficult to assert that these passages are not germane to the consolidated tax savings issue.

The Court of Appeals cites only two cases in support of its contention that these passages are *dicta*. *Id.* One

of these is its own *Charlottesville I* opinion. The Court of Appeals' citation of its earlier opinion in this litigation to support its assertions should be given no weight.[13]

The other opinion that the Court of Appeals cited in support of its assertion was *Tenneco Oil Co. v. FERC*, 571 F.2d 834 (5th Cir.), *cert. denied*, 439 U.S. 801 (1978) ("*Tenneco*"). *Charlottesville II*, 774 F.2d at 1216 (App. 22a). In *Tenneco*, the Fifth Circuit reviewed certain opinions of the Commission establishing rates applicable to natural gas producers (rather than an individual interstate pipeline) for natural gas from wells commenced prior to January 1, 1973. One of the cost-of-service elements that the Commission included in its generic rate was an FIT allowance. It calculated this allowance on an industry-wide basis, without examining individual producers' FIT returns. Certain consumer interests opposed the generic FIT allowance (i) because the Commission had not examined producers' actual tax returns and (ii) because the Commission had found in earlier producer rate opinions that producers generally did not pay tax at the statutory rate. *Tenneco*, 571 F.2d at 842. The Fifth Circuit dismissed both contentions, noting that *United* was no bar to the Commission's generic approach:

> The cited cases do not obstruct the Commission's path. *United Gas* contained a phrase referring to "the power and the duty of the Commission to limit cost of service to real expenses," 386 U.S. at 245, 87 S.Ct. at 1008, but the use of the word "duty" was dictum. The holding went no further than saying the Commission could, if it so chose, take nonjurisdictional tax savings into account when calculating

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[13] Of course, since *Charlottesville I* reversed and remanded this case to the Commission, the City had no reason at that time to petition this Court for certiorari to seek review of the Court of Appeals' interpretation of the *United* case. This Court, however, has jurisdiction to consider all the substantial federal questions determined in the earlier stages of a litigation before it for review. Mercer v. Theriot, 377 U.S. 152 (1964); R. Stern and E. Gressman, *Supreme Court Practice* § 6.4 (5th ed. 1978).

> jurisdictional income. *American Public Gas Ass'n*, 186 U.S. App. D.C. at 46, 567 F.2d at 1039.

Tenneco, 571 F.2d at 843.

The *Tenneco* decision, however, supports the City's position. The Fifth Circuit found that the Commission's generic FIT allowance, while not based on producers' actual returns, did attempt to approximate their real-world tax liability within the constraints of a generic ratemaking proceeding:

> The nature of the problem justifies reliance on an economic model rather than a survey of test year tax returns. The choice was not between the unknown and the known, but rather between the satisfaction of theory and the frustration of data not compiled for the use to which it would be put. When material, company tax returns would have been consolidated. While it might be possible to separate the tax burden on gas and non-gas income, it would have been far more difficult to make the necessary breakdown between the burden on new gas and the burden on flowing gas, a distinction unfamiliar in the world outside the regulations of the Commission. Speculation would have been necessary. Even the final tax burden figure at which the Commission arrived would have been an average, and perforce would have been somewhat hypothetical. The data, based on the past, would not have reflected the effect of depletion repeal, nor would it have shown the impact of the additional income produced by the higher prices allowed by this rate.
>
> The Commission's model avoided such difficulties, but at the same time preserved important elements of the "actual taxes paid" principle by taking into account the tax impact that flowing gas intangible drilling costs would have on production net income. *American Public Gas Ass'n*, 186 U.S. App. D.C. at 45, 567 F.2d at 1038.

* * * *

> The Commission has not shown that its income tax component is strictly cost-justified. *It has, however, made a reasonable effort to construct a rate element that would confront the reality of the tax laws rather than pretend they do not apply.* We affirm the Commission's use of an income tax component not because of what we find in the record, but because of the reasoned consideration the Commission has given the problem. That is all the Natural Gas Act requires.

Id. at 843-44 (emphasis added).

The *Tenneco* case is thus consonant with the above-quoted passages from the *United* case. Both cases instruct the Commission to make "reasonable efforts" to "confront the reality of the tax laws" in calculating FIT allowances. The Fifth Circuit's refusal in *Tenneco* to require the Commission to consult actual tax returns clearly stemmed from the generic nature of the ratemaking proceeding there under review, a format which would render impossible close examination of thousands of producers' tax returns.[14] Thus, it can hardly serve as support for the Court of Appeals' assertion that the *United* decision has no force in a pipeline rate proceeding.

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[14] This same logistical problem dictated the result in American Public Gas Association v. FPC, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978) (*"APGA"*), which is cited in *Tenneco* (571 F.2d at 843). In *APGA*, the Court of Appeals, while it noted that the Commission claimed that the *United* case "did not mandate a specific formula for the allocation of tax savings," found it unnecessary to reach this legal issue. *APGA*, 567 F.2d at 1039. The Court of Appeals in *APGA*, like the Fifth Circuit in *Tenneco*, upheld the use of an economic model to develop a generic FIT allowance for natural gas producers in a nationwide natural gas producer ratemaking proceeding. The Court of Appeals rejected the objections of consumer interests that the Commission was bound to use actual producers' tax returns in developing the allowance, finding that the Commission's use of an economic model passed tax savings through to natural gas consumers and that no deviation from the "actual taxes paid doctrine" therefore occurred. *Id.* at 1038.

In fact, review of later cases discussing *United* show that the case is still considered and relied upon as valid precedent. While this Court until now has had no occasion to revisit the consolidated tax issue, it has continued to cite *United* in its natural gas opinions. *See, e.g., FPC v. Memphis Light, Gas and Water Division*, 411 U.S. 458, 466-67 (1973) (citing *United* for the proposition that the Commission has the jurisdiction to determine a proper FIT allowance as part of a natural gas company's cost of service); *Maryland v. Louisiana*, 451 U.S. 725, 748 (1981) (to the same effect); *Exxon Corp. v. Eagerton*, 462 U.S. 176, 185 (1983) (to the same effect).

The Court of Appeals itself has cited the *United* case for the proposition that the rates of regulated entities should reflect only expenses actually incurred. *See, e.g., Public Utilities Commission of Colorado v. FERC*, 660 F.2d 821, 826 (D.C. Cir. 1981), *cert. denied*, 456 U.S. 944 (1982) (citing *United* for the proposition that the Commission has the power to reduce rates based on the application of non-jurisdictional losses to jurisdictional income when it results in tax savings to the jurisdictional company); *Public Systems v. FERC*, 606 F.2d 973, 978 n. 24 (D.C. Cir. 1979) (quoting *United's* language regarding the "power and the duty of the Commission to limit cost of service to real expenses"); *Memphis Light, Gas and Water Division v. FPC*, 500 F.2d 798, 807 (D.C. Cir. 1974) (citing *United* for the proposition that "rates of utilities are supposed to reflect actual payments"); and *Williams v. Washington Metropolitan Area Transit Commission*, 415 F.2d 922, 962 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1081 (1969) (quoting *United's* "admonition" limiting "costs of service to expenses actually incurred," and noting that deviations from this principle can only be tolerated if "solidly justified" by a balancing of the interests of the regulated company, its shareholders, the consumer, and the public).

Other United States Courts of Appeals recently have also relied on the *United* decision. *See, e.g., Papago Tribal Utility Authority v. FERC*, 773 F.2d 1056, 1065 (9th Cir. 1985) (Ninth Circuit upheld FERC decision requiring electric utility to share with its ratepayers the tax benefits accruing from a specific leasing transaction, citing *United*); *Rochester Gas and Electric Corp. v. Public Service Commission of New York*, 754 F.2d 99, 103 (2d Cir. 1985) (citing *United* for the proposition that the Commission has the power to reduce jurisdictional rates based on the application of nonjurisdictional losses to jurisdictional income); *Indianapolis Airport Authority v. American Airlines, Inc.*, 733 F.2d 1262, 1265 (7th Cir. 1984) (Seventh Circuit (Posner, J.) invalidated airport user fees imposed by an airport authority which disregarded income obtained from unregulated airport concessionaires, citing *United* and noting that the Court had held in *United* that it was "proper" to take consolidated tax savings into account in setting pipeline rates.)

Finally, numerous state courts have relied upon the *United* decision in affirming decisions of state public utility commissions requiring state-regulated public utilities to share their consolidated tax savings with their ratepayers.[15]

The Court of Appeals interprets *United*, notwithstanding its express language to the contrary, to be entirely precatory, permitting the Commission to disregard a regulated pipeline's participation in a consolidated return in calculating its FIT allowance:

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[15] *See, e.g.*, Washington Gas Light Co. v. Public Service Commission of the District of Columbia, 450 A.2d 1187, 1234 (D.C. App. 1982); Connecticut Natural Gas Corp. v. Public Utilities Control Authority, 183 Conn. 128, 439 A.2d 282, 289-90 (1981); Michaelson v. New England Telephone and Telegraph Co., 121 R.I. 722, 404 A.2d 799, 809-10 (1979); Mountain States Telephone and Telegraph Co. v. Public Utilities Commission of Colorado, 195 Colo. 130, 576 P.2d 544, 549-51 (1978) (*en banc*).

> The object of the present exercise is not theoretically accurate assignment of causality for the tax advantages of consolidated filing, but estimation of the tax liability attributable to operations of a regulated company that happens to be an affiliate. There are a number of plausible ways to make that estimation —ranging, perhaps, from an approach that would give the utility's ratepayers the benefit of all tax deductions of the consolidated group offset against the utility's income (since the deductions would have been worthless without the income) to an approach that would give ratepayers the benefit of none of them (since the utility would have had no deductions on its own). Within certain rational limits that have clearly not been exceeded here, which approach to choose is more a matter of regulatory policy than of logic. The approach the Commission has chosen, allowing those deductions made possible by charges to the ratepayers, is an entirely reasonable one, beyond our authority to upset. *See FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 246, 87 S.Ct. 1003, 1008, 18 L.Ed.2d 18 (1967); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 589, 65 S.Ct. 829, 833, 89 L.Ed. 1206 (1945); *Charlottesville I*, 661 F.2d at 952.

Charlottesville II, 774 F.2d at 1221 (App. 32a). According to the Court of Appeals, the Commission can disregard consolidated tax savings even if the pipeline's consolidated group pays no federal income taxes at all. *Id.* at 1215 (App. 20a-21a).

The City, on the other hand, believes that the plain language of the *United* case requires the Commission to recognize a pipeline's consolidated tax savings in some fashion in setting its FIT allowance, although the Commission is free (within reasonable limits) to select the particular method of sharing the consolidated tax savings. The sole rationale given by the Court of Appeals in *Charlottesville II* for holding that the Commission had the legal authority to adopt a "stand-alone" policy in the face of *United*, *i.e.*, the "economic detriment"

theory, stands the *United* case on its head. The very reason this Court gave in *United* for sustaining the sharing of consolidated tax savings now has been offered up by the Court of Appeals as the basis for reaching the opposite result. It is this fundamental disagreement regarding the continuing vitality of the *United* decision that the City now asks this Court to resolve.

II. THE COURT OF APPEALS ERRONEOUSLY CONCLUDED THAT THE COMMISSION HAD NO OBLIGATION EVEN TO ATTEMPT TO APPROXIMATE THE COLUMBIA PIPELINES' SHARE OF THE COLUMBIA GAS SYSTEM INC.'S FEDERAL INCOME TAX LIABILITY

The Court of Appeals in *Charlottesville II* also discussed a number of other cases besides *United* in which the Commission's duty to limit FIT allowances to the "actual taxes paid" was at issue. It concluded from its review of these cases that the "actual taxes paid" doctrine "should be expressed 'actual or estimated taxes paid or incurred'—whereupon it ceases to constrain the Commission with regard to taxes any more than the Commission is constrained with regard to its treatment of other expenses." *Charlottesville II*, 774 F.2d at 1215 (App. 20a). The City, however, never argued that taxes should be given preferred treatment over other expenses; it asked only that the Commission be required to recognize in some fashion the existence of the Columbia Pipelines' consolidated tax savings. The cases discussed by the Court of Appeals do not gainsay the City's position.

The cases that the Court of Appeals cited in its discussion of the "actual taxes paid" principle fall into two general categories. The first category consists of cases involving natural gas producer rate proceedings, in which courts permitted the Commission to develop a generic FIT allowance based on aggregate data or economic models, *e.g.*, *Tenneco* and *APGA*. These cases are distinguishable

because of the generic nature of the ratemaking proceedings involved. *See, e.g., City of Chicago v. FPC*, 458 F.2d 731, 756 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972) ("When a company's rates are set under individual cost-of-service, then only actual costs—tax and other—can be included. When area rates are used, however, all elements of cost on which the rate is based are to some degree hypothetical. . . .").

The other general category of cases that the Court of Appeals discussed concerns the reconciliation of book-tax timing differences.[16] Book-tax timing questions have been litigated in the courts for many years, as the Commission has revised its policies for dealing with such timing differences. The Commission's current policy (denominated "normalization") is that the FIT allowance should not be immediately decreased to reflect the "actual" FIT liability. Rather, the difference between the "actual" FIT liability and the FIT allowance is credited to a deferred account, so that the monies will be available to the pipeline to pay the excess of its actual FIT liability over its FIT allowance after the cross-over point occurs. *See Public Systems v. FERC*, 709 F.2d 73 (D.C. Cir. 1983).

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[16] A book-tax timing difference arises when a pipeline defers a tax liability in accordance with the tax laws, but calculates its FIT allowance for ratemaking purposes on a "normalized" basis, *i.e.*, as if the tax expense were not deferred. A classic example is depreciation. Under the tax laws, pipelines may depreciate an asset on an accelerated schedule, taking greater depreciation deductions in the early years of an asset's useful life and less during the later years. The Commission, on the other hand, has generally specified that assets be depreciated on a "straight-line" basis for ratemaking purposes. Thus, in the early years of a particular asset's useful life, the pipeline would take more depreciation for tax purposes (resulting in a lower overall actual FIT liability) than would be reflected in its FIT allowance for ratemaking purposes. In later years, however, *ceteris paribus*, the actual FIT liability would be higher than the FIT allowance, since the depreciation deduction on a given asset would then be less than the straight-line deduction.

The Court of Appeals cites several cases concerning such book-tax timing differences [17] as support for its conclusion that the "actual taxes paid" principle does not bar the Commission from permitting pipelines to keep their consolidated tax savings. *Charlottesville II*, 774 F.2d at 1213-15 (App. 16a-20a). These cases, however, unlike the instant case, do not involve permanent tax savings. The Court of Appeals itself explained the distinction:

> By definition, timing differences do not result in permanent differences in the ratemaking and tax books. Every difference that arises in one period will exactly reverse itself in one or more subsequent periods. Regardless of whether flow-through or normalization is employed, over time the ratemaking and tax accounting procedures will recognize the same amount of revenue or expense with respect to each transaction. In contrast, permanent differences are not offset by reversals in other periods. Permanent differences arise when the tax law places a different dollar value on a revenue or expense than does the ratemaking law . . . . Permanent differences are not within the scope of the rules under review in this case.

Public Systems v. FERC, 709 F.2d 73, 76 (D.C. Cir. 1983). Hence, these cases, like the generic producer ratemaking cases, cannot support the Court of Appeals' ruling that the Commission is free to permit pipelines to retain permanent consolidated tax savings, despite the "actual taxes paid" principle.

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[17] El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961); City of Lexington v. FPC, 295 F.2d 109 (4th Cir. 1961); Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966); City of Chicago v. FPC, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied*, 390 U.S. 945 (1968); Memphis Light, Gas and Water Division v. FPC, 500 F.2d 798 (D.C. Cir. 1974); Public Systems v. FERC, 606 F.2d 973 (D.C. Cir. 1979); Public Systems v. FERC, 709 F.2d 73 (D.C. Cir. 1983); FPC v. Memphis Light, Gas and Water Division, 411 U.S. 458 (1973).

III. THE COMMISSION'S METHOD OF CALCULATING PIPELINE FEDERAL INCOME TAX ALLOWANCES DOES NOT SHARE CONSOLIDATED TAX SAVINGS WITH PIPELINE RATEPAYERS; HENCE, IT CANNOT STAND UNDER UNITED AND THE "ACTUAL TAXES PAID" PRINCIPLE

The Commission in Opinion No. 173 put forth an elaborate theory supporting the adoption of its "stand-alone" policy, known as the "benefits/burdens" test. Simply put, this theory would give pipeline ratepayers the "benefit" of a tax savings if, and only if, the ratepayers bore the "burden" of the expense that resulted in the deduction giving rise to the tax savings. *Charlottesville II*, 774 F.2d at 1217 (App. 23a-24a).

This beneficent-sounding theory, however, clashes sharply with the results that obtain under the "stand-alone" method. The Commission itself in Opinion No. 173 stated that the stand-alone method "results in a tax allowance equal to the tax on the allowed return on equity." Opinion No. 173, 23 FERC (CCH) ¶ 61,396 at p. 61,852 (1983) (App. 49a). As the Court of Appeals acknowledged, this would be the result even if the consolidated group of which the pipeline was a member paid no federal income taxes at all. *Charlottesville II*, 774 F.2d at 1215 (App. 20a-21a).

Such a result cannot be justified by the "benefits/burdens" test or any other theoretical construct. As this Court stated many years ago, "[u]nder the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). The result that the Commission and the Court of Appeals have reached here is plainly unjust and unreasonable, as well as contrary to *United* and the numerous other cases supporting the "actual taxes paid" principle.

CONCLUSION

For the reasons stated above, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals.

Respectfully submitted,

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